POLICY REPORT

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How the Personal Income Tax Distorts the Labor Market

by James E. Long

Taxation and government spending have impacts on the economy beyond those of raising revenue and providing goods and services and income. By affecting the choices of consumers, producers, and resource suppliers, most taxation and expenditure policies create distortions that result in "excess burdens" or "welfare costs." If such costs are not included in assessments of government spending, then the total costs of governmental programs are systematically underestimated.

This discussion outlines the various ways that the federal individual income tax distorts the labor market. For example, the income tax encourages the substitution of leisure activities for income-earning labor market activity, and it induces workers to substitute tax-preferred fringe benefits for cash wages and salaries. It will be shown that the welfare costs of the income tax vary directly with individuals' marginal tax rates, which rose substantially during the 1970s owing to the combination of inflation and a progressive tax structure. Sen. William V. Roth Jr. (R-Del.) has pointed out that the typical factory worker was in the 16 or 17% tax bracket in 1965, in the 22% bracket in 1979, and will be in the 25% bracket by 1983 unless tax brackets are widened or rates reduced.[1] IRS tax returns data show that the proportion of taxable returns facing a marginal tax rate of 25% or more has risen from 8% in 1966 to over 38% in 1976. Because of this increase in marginal tax rates, the welfare costs of income taxation are much higher today than previously thought. The presence of high welfare costs strengthens the case for the income tax rate reductions proposed by the Reagan administration.

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It may be helpful to illustrate the "welfare cost" concept by reference to government policies that distort product markets. Economists have generally not given as much attention to labor market distortions resulting from income taxation as they have to welfare costs resulting from policies that subsidize consumption of various goods and services.

"The income tax encourages individuals to substitute leisure activities for income-earning labor market activity, and to substitute tax-preferred fringe benefits for cash wages and salaries."

Some government subsidies allow certain consumers to purchase goods and services at reduced prices. For example, tuition for in-state students at state-supported colleges and universities is lower than the actual cost of providing educational services. This practice encourages students to substitute in-state public education for schooling at private or out-of-state institutions, which results in a welfare cost.

Other government subsidies are in the form of income tax deductions. A familiar example is the deductibility of mortgage interest payments, a practice that lowers the "effective" price of homeownership and induces a substitution of owner-occupied housing for other goods and services not deductible under the federal income tax. If the income tax were levied proportionally at a rate of 30% and no deductions, exemptions, or exclusions were permitted, then an individual with an annual income of $30,000 would pay $9,000 in taxes. However, if $5,000 of mortgage interest could be deducted, taxable income would fall to $25,000 and the same person would owe only $7,500 in taxes. The same tax revenue ($7,500) could also be raised by taxing total income ($30,000) at a rate of only 25%. But a comprehensive tax base with a lower tax rate would make the individual better off because housing consumption would not be distorted. The individual might decide to spend less on owner-occupied housing and more on rental housing, recreation, travel, tuition for private schools, and other goods and services. In other words, by artificially reducing the price of home ownership, the tax deduction leads to overconsumption of housing, which results in an excess burden or welfare cost.[2]

The Distortion of Consumer Choices

The common factor in these examples of welfare costs is a price reduction that distorts choices by encouraging the consumer to substitute a particular product for others. What substitutions are induced in the labor market by the individual income tax? An obvious substitution is that of leisure and nonmarket activities for income-earning market work. When a worker who can earn $10 per hour faces a marginal tax rate of 30%, his net or after-tax wage is reduced to $7 an hour. The income tax drives a wedge between the gross wage (the value of labor to the economy) and the net wage (the value of work time to the individual). Taxation reduces the price of not working in the sense that the

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EDITORIAL

A Call for Free Elections

In the 1980 New Hampshire primary Ronald Reagan's campaign committee exceeded legal spending limits by $137,000, or nearly 47% of the allowable amount. His campaign also exceeded the $14 million national ceiling by $77,000.

Now, we don't mean to urge the FEC to throw out the results of the election, nor do we favor tightening up the election laws. But these facts raise a difficult question for advocates of strict election laws: Are the laws going to be enforced or not?

President Reagan won the crucial New Hampshire primary by, to put it bluntly, cheating—breaking the law. If he had not overspent the legal budget by 47%, perhaps he would not have won that primary. If he had lost the New Hampshire primary—on the heels of his defeat in Iowa—he might very possibly have lost the Republican nomination and thus the presidency.

If we are supporters of the current election laws, then, we are faced with a disturbing question: Did candidate Ronald Reagan win the presidency by breaking the law, that is, by not abiding by the rules set down by Congress?

If so, what does this say about the system? What good are the laws if they can be broken with impunity? Why should any candidate abide by spending limits if some candidates are going to exceed them?

By now the reader may be wondering what the FEC intends to do about his violation. The answer is that the Reagan campaign was fined $215,000—the total of the two amounts by which, it is charged, he overspent. That's a small price to pay for the presidency.

Regular readers of *Policy Report* may have guessed that our concern about the foregoing is somewhat less than serious. In fact, we believe that the 1974 campaign laws are an unconscionable violation of free speech and of the free electoral process. While we deplore the tremendous power of government that makes politicians and special interests willing to spend so heavily to get control of government, we nevertheless believe that candidates must be free to spend whatever they choose in the effort to get elected. After all, campaign spending is only one of the factors that help a candidate get elected. Incumbency, name recognition, and editorial support are all important. Indeed, in a lower-profile race than the presidency, it is almost essential for a challenger to outspend an incumbent if he is to have any chance at all. And surely no one proposes to limit the right of a newspaper to editorialize on behalf of its favorite candidate. But why should Katharine Graham, the chairman of the board of the Washington Post Co., be able to help her choice with an editorial endorsement, while the chairman of General Motors is limited to a $1,000 contribution?

The abuses of the FEC have become all too clear. It took three years to audit the 1976 Carter campaign. What if major violations of the law had been uncovered in that campaign? And yet at the same time that the Carter audit was dragging along, audits were also being performed on minor presidential candidates—candidates, in many cases, who spent only a few hundred thousand dollars and got only a fraction of 1% of the vote. What possible "corruption" could be uncovered in the records of such minor candidates? Or is one of the FEC's functions to discourage such challengers to the established parties?

The FEC has gone well beyond candidates and campaigns, as well. It once brought charges against the Long Island, New York, branch of TRIM, a John Birch society-controlled tax protest group, because the group had spent $137 to distribute pamphlets criticizing the voting record of an incumbent congressman. Nowhere did the pamphlet urge the election of any other candidate or the defeat of the incumbent—yet the FEC called the $137 an unreported campaign expenditure.

A few months ago the FEC began an inquiry into the possibility that *Reader's Digest* had made illegal corporate campaign expenditures to "negatively influence" Sen. Edward Kennedy's presidential campaign. The *Digest*, in connection with an article in the magazine, had distributed to other media videotapes of a computer reenactment of Kennedy's Chappaquiddick accident. The *Digest* sued on grounds of infringement of its First Amendment rights, but the court actually upheld the FEC's right to conduct an inquiry.

A poll conducted recently by the survey research firm of Civic Service, Inc., found that 62% of the American people oppose public financing of presidential campaigns. An even larger majority oppose extending public financing to congressional campaigns.

We conclude this editorial not with a demand that the FEC declare the 1980 election null and void and throw President Reagan out of office, but rather with a call for free elections. The 1974 election laws should be repealed, the FEC should be abolished, and candidates should be free to raise and spend their own funds without forcing the taxpayers to subsidize them. As long as we have such a powerful government, special interests will spend heavily to gain control over it, but a justly suspicious public will be a better safeguard than the bumbling, dangerous FEC. Assuming that voters are concerned about the candidates' sources of funds, they could insist on full disclosure through timely audited financial statements. Candidates would actually compete to make full disclosure once it became clear that voters would insist on it. Voters would know what they want to know, but our electoral process would be free of the heavy hand of the FEC. ■

The Income Tax (Cont. from p. 1)

individual sacrifices fewer dollars of income by not working and induces a substitution of leisure, home work, school, etc., for time spent working for pay. At the same time, the reduced net wage leads to lower income for the worker, which may force him to work longer hours to maintain previous levels of consumption and saving. In technical terms, the income tax creates a substitution effect that discourages work and an income effect that encourages work. An individual will work less (more) when the marginal tax rate rises—and the net wage falls—if the substitution effect is stronger (weaker) than the income effect. If these two effects are exactly offsetting, an increase in the marginal tax rate will not affect the quantity of labor supplied to the market.

It is important to recognize, however, that a tax on labor income imposes a welfare cost even if the substitution and income effects cancel out. The welfare cost results from the substitution effect, which induces an overconsumption of leisure, and this welfare cost exists even if the combined effect of the income and substitution effects is zero. That is, the taxpayer would be harmed less, yet the same tax revenue raised, if a lump-sum tax (the reverse of a lump-sum cash grant) were levied in place of an income tax that reduces the price of leisure.

Recent proposals to reduce income tax rates have renewed interest in the question, "Do taxes reduce work effort?" Opponents of tax rate reductions point to econometric studies suggesting that tax rate changes will not affect the work effort of prime-age married males. Consequently it is argued that tax rate cuts will be inflationary because demand for goods and services will rise, but the supply of labor and products will not increase. This argument has several weaknesses. First, the aforementioned welfare cost of the income tax would be reduced by cutting marginal tax rates. Second, empirical research suggests that other workers, such as married women and older persons, will work more in response to higher net wages. Finally, it is important to recognize that income tax revenues finance various income-transfer and welfare programs. Income and in-kind transfers make recipients better off by raising their incomes (which discourages them from working) while taxes to finance such transfers lower taxpayers' incomes (which encourages work). Transfer recipients are taxed implicitly in the sense that transfers are reduced as earnings rise. For example, if earning an additional $100 a month results in welfare, food stamps, and housing supplements falling by $70, then the implicit marginal tax rate is 70%.[3] Thus both taxpayers and transfer recipients confront marginal tax rates that induce a substitution of leisure for market work. If the income effects confronting taxpayers and transfer recipients are assumed to cancel out, then it seems clear that reducing tax rates and transfers will encourage greater work effort in the economy.

Distortions in the Labor Market

Nevertheless, suppose that the aggregate labor supply curve is assumed to be vertical (i.e., cutting tax rates will not change the total quantity of work effort). Does it follow that the only distortion or welfare cost of income taxation is the leisure-labor substitution outlined above? The answer is no, because the income tax is likely to have greater impact on the allocation of labor among different types of employment than on total labor supply (i.e., the allocation of time between work and nonwork). This follows from the "law" that labor supply to any particular activity will be more sensitive to the net wage rate than aggregate labor supply. For example, falling salaries in academia will tend to decrease the number of teaching economists while increasing the number of economists seeking jobs in industry and government; decreasing real wage and employment prospects in the civilian sector will increase enlistments in the armed services; reduced earnings among criminal lawyers will reduce their numbers and increase labor supply in other areas of law. With this principle established, we can consider some other labor market distortions induced by income taxation.

First, high marginal tax rates encourage

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The Income Tax (Cont. from p. 3)

individuals to substitute "leisure intensive" jobs for "income intensive" ones.[4] For example, rising tax rates may induce a business economist to shift into university teaching or research, a profession whose nonpecuniary advantages (security afforded by tenure, flexible hours, etc.) compensate for its relatively low salaries. Since such nonpecuniary advantages are not taxed, this substitution reduces the tax burden of the individual. But, recalling the example of mortgage interest deductibility, the same tax revenue could be raised without the substitution effect or welfare cost if the income tax base were comprehensive.

Another substitution is that of time spent sheltering income from taxes for time spent working professionally. Suppose an architect can provide professional services worth $100 an hour to his client. Alternatively, time devoted to acquiring and overseeing depreciable property (duplexes, house trailers, office buildings, etc.) can yield $70 an hour through generating paper losses that can be used to offset the architect's professional earnings. If the architect is in the 40% tax bracket, it will be rational for him to substitute tax-sheltering time for professional work. As marginal tax rates increase, labor resources will be diverted away from projects that are more productive for society and into activities that are profitable only because of the tax-savings they provide.[5] Consequently, as Milton Friedman noted in *Newsweek* (18 August 1980, p. 68), by reducing marginal tax rates the nation can reap a productive windfall through improvements in the allocation of labor and other resources.

A third labor substitution, unlike the ones mentioned above, is illegal tax avoidance—that is, tax evasion. High tax rates encourage all individuals to substitute work in the underground economy for work in the taxed economy. The incentive to work in the underground economy is probably greatest for low-income workers since, as noted earlier, they confront the highest (implicit) tax rates. Reliable data on employment in illegal activities is obviously not available, but anecdotal evidence (such as the increase in the ratio of currency to demand deposits) suggests that the underground economy is large (generating income equal to 10% of recorded GNP) and growing.[6] Since tax rates have also been rising, the growth of the underground economy is consistent with the view that income taxation induces labor to shift from taxed into untaxed areas.

> "By artificially reducing the price of homeownership, the tax deduction leads to over-consumption of housing, which results in an excess burden or welfare cost."

A fourth distortion induced by the income tax is the substitution of self-employment for wage and salary work. At first glance the individual income tax appears "general" in the sense that its impact is the same on returns from all types of employment. For example, under a proportional income tax with a 30% rate, an additional dollar earned by an accountant and one earned by a plumber would each provide only 70 cents of spendable income. Of course, the actual federal income tax is progressive, and thus higher-income workers are taxed more at the margin than lower-income workers, but in practice even a simple proportional tax would not be perfectly general and uniform. Besides the fact that leisure and nonpecuniary incomes are not taxed, several other factors suggest that incomes from self-employment are less heavily taxed than wages and salaries. First, taxation of self-employed persons depends primarily on voluntary compliance, whereas income taxes on wages and salaries are withheld by employers. It is not surprising that studies indicate that a larger percentage of farm, business, and professional income is unreported, which means that "effective" or actual tax rates are lower for the self-employed. Second, self-employed workers can greatly reduce their taxable income through deductions for the cost of entertainment, autos, housing, travel, and other expenses. Even when such expenditures serve business purposes, the self-employed worker may still receive personal benefits. Finally, a self-employed person can achieve substantial tax savings by using corporate entities to shield his income from the personal tax rates on wage and salary income. The owner of a closely held corporation may arrange to pay himself a "reasonable" salary while leaving the balance of corporate income to be taxed at rates not exceeding 46%, thereby increasing the opportunity to reinvest in his business.

The Increase in Self-Employment

Operating one's own business can be very costly, but as income tax rates rise it may be rational to incur such costs if the self-employed are less heavily taxed than other workers. U.S. Bureau of Labor Statistics data cited recently in the *Wall Street Journal* (9 March 1981, p. 25) are consistent with the theory that rising tax rates induce labor to shift from wage and salary jobs into self-employment. From 1976 to 1979 the number of self-employed nonagricultural workers grew by 17%, to 6.7 million. This total undercounts the number of self-employed workers since owners of incorporated firms are considered employees of the corporation they own rather than self-employed. Even so, the number of self-employed increased from 6.7% of total employment to 7.1%. Empirical evidence suggests that rising income tax rates are partly responsible for the relative increase in self-employment.[7] That self-employment grew at all during the 1970s is somewhat surprising because it is generally thought that high rates of inflation, mounting government regulations and paper work, and increased inheritance taxes disproportionately burden small proprietorships and owner-operated businesses. In addition, the proportion of women in the labor force has steadily risen, and women are less likely to be self-employed than men. The relative

growth of self-employment in spite of these factors may be strong evidence that high taxation induces a labor substitution toward self-employment.

As indicated, differentials in effective rates of income taxation will induce labor to flow from wage and salary jobs into self-employment. For example, as tax rates rise accountants may leave firms that specialize in corporate tax planning in order to establish their own professional practices catering to the tax planning needs of individuals. When this occurs in competitive labor markets, before-tax salaries of accountants will be bid up as accounting firms try to fill vacancies, whereas the increased supply of self-employed accountants will tend to reduce what they can charge individual consumers. These labor supply shifts will continue until after-tax returns to labor are equal in all types of employment. For instance, supply shifts would cease when salaried accountants were earning $20 per hour and facing a marginal tax rate of 40%, whereas self-employed accountants were receiving $18 an hour but through various deductions for business expenses were being taxed at only 33%. Notice that these tax rate differentials will divert labor from its most efficient allocation. After-tax returns to labor will be equal (i.e., at $12 per hour in this case), but gross or before-tax returns will be higher in wage and salary work than in self-employment. Efficiency requires that the gross returns to labor be equalized, i.e., an additional hour of work produces the same value of services whether one is self-employed or working for someone else. This misallocation of labor imposes a welfare cost of unknown size, conceptually similar to that associated with the corporate income tax.[8]

Fringe Benefits

This discussion would not be complete without mentioning a substitution that occurs in the labor market because employers' supplements to wages and salaries, or "fringe benefits," receive preferential tax treatment. For example, employers can provide limited amounts of group term life insurance and health insurance that are not taxable as employee income. Also, employees do not pay taxes on the value of their employer's contributions to qualified pension plans until such contributions and the earnings they generate are withdrawn. This fringe benefit provides a tax savings for workers anticipating a lower tax bracket in their retirement years than their current tax bracket. The impact of the preferential tax treatment is to reduce the effective prices of fringe benefits. Suppose an employee can receive a pay raise in one of two forms: (1) an additional $100 per month cash salary or (2) an equivalent employer contribution to a group health insurance plan. For a worker in the 30% tax bracket, the price of choosing the health insurance is only $70, i.e., the worker sacrifices $70 of net income that could be used to purchase goods and services. If the tax rate were 40%, the cost of group health insurance would fall to $60. As marginal tax rates increase, workers are induced to substitute fringe benefits for cash wages and salaries.

> "Both taxpayers and transfer recipients confront marginal tax rates that induce a substitution of leisure for market work."

In the United States voluntary employer expenditures on fringe benefits have risen from 2% of wage and salary income in 1947 to 10% in 1979, with half the increase taking place since 1969. Major changes in the composition of fringe benefits have also occurred during this period. Employer contributions to group health insurance plans have risen from 16% of total fringe benefits in 1947 to 39% in 1979, whereas pension and profit-sharing contributions have declined as a fraction of fringes. Econometric analyses suggest that the relative growth of fringe benefits as a form of labor compensation has been hastened by the increase in income tax rates documented earlier in this discussion.[9] Statistically the impact of income taxation on fringe benefit growth has been greater for group health insurance than for pension and profit-sharing plans, which is to be expected given that insurance contributions are tax-free, but pension contributions are only tax-deferred.

If other things are equal, employees will prefer direct cash compensation to fringe benefits and other in-kind compensation because with the former they can choose any combination of goods and services (including insurance or pensions) that they desire. Other things are not equal, however; fringe benefits receive preferential tax treatment that distorts the taxpayer's choices by artificially lowering the effective prices of fringe benefits, leading to an over-compensation of fringe benefits. The result is a welfare cost, similar to that associated with government subsidization of higher education and owner-occupied housing, estimated to have been $5.1 billion in 1978, or close to 3% of federal income tax revenues in that year.[10]

Because this list of welfare costs has reached a length that makes recall difficult, a brief summary of the labor market distortions due to income taxation is in order. The income tax induces individuals to substitute (1) leisure for labor, (2) "leisure-intensive" jobs for "income-intensive" jobs, (3) "tax-sheltering" activities for professional work time, (4) "underground" work for work in the taxed economy, (5) self-employment for wage and salary work, and (6) fringe benefits for cash wages and salaries. Economists have managed only to approximate the welfare costs associated with the first and last of these substitutions, which in 1978 were probably about $15 billion, or almost 8% of federal income tax revenues. The combined welfare costs of the remaining substitutions are probably much higher, assuming that the labor supply to any particular type of work is relatively sensitive to the net wage. Even if we assume that these additional welfare costs are also only $15 billion, once administrative and compliance costs are added the total welfare

cost of the federal income tax would equal about 18% of tax revenues.[11] It seems likely, therefore, that many federal expenditures financed by income taxation are not producing a net welfare gain despite the claims of many proponents. ■

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[1]William Roth, "In Defense of Roth-Kemp," *Taxing and Spending*, July 1979, p. 3.

[2]In "Federal Taxes and Homeownership: Evidence from Time Series," *Journal of Political Economy*, February 1980, pp. 59–75, Harvey Rosen and Kenneth Rosen estimate that about one-fourth of the increase in homeownership in the United States since 1945 can be attributed to the tax treatment of owner-occupied housing. This tax treatment may not lead to a misallocation of resources (i.e., a welfare cost) if increased homeownership provides external benefits. However, the externality argument for tax deductions is thought to be weak. See E. K. Browning and J. M. Browning, *Public Finance and the Price System* (New York: Macmillan Co., 1979).

[3]The 70% figure is not unrealistic. For example, Martin Anderson reports that for a California family of four the implicit marginal tax rates on earnings between $576 and $8,390 in 1976 varied between 67 and 80%. See his book *Welfare* (Stanford, Calif.: Hoover Institution Press, 1978) for further discussion of the work-discouraging impact of transfer payments.

[4]This and the following substitution are suggested by James Gwartney, "Some Thoughts on the Economics of Redistribution," unpublished paper, Florida State University, 1980.

[5]While such labor substitutions surely occur, no direct evidence on their magnitude exists. However, it is interesting to note that IRS data show that the number of partners per nonfarm business partnership has risen from 3 in 1964 to 5.11 in 1976. Since the number of partnerships has also increased, this may indicate that more individuals are seeking tax-savings through involvement in partnerships.

[6]"The Fast Growth of the Underground Economy," *Business Week*, 13 March 1978, pp. 73–77.

[7]Another factor leading to a rise in the relative number of self-employed workers has been the growth of service industries. For empirical estimates of the determinants of self-employment activity, see James E. Long, "The Income Tax and Self-Employment," unpublished paper, Auburn University, November 1980.

[8]See Arnold Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, June 1962, pp. 215–40.

[9]James E. Long and Frank A. Scott, "The Income Tax and Nonwage Compensation," unpublished paper, Auburn University, March 1981.

[10]Ibid., p. 18.

[11]Administrative and compliance costs of the federal income tax are thought to be around 2–2.5% of tax revenue. See R. Musgrave and P. Musgrave, *Public Finance in Theory and Practice* (New York: McGraw-Hill, 1973), p. 460.

A Proposal for Monetary Reform: The 100% Gold Standard

by Joseph T. Salerno

Few would now deny that the inflationary recession or "stagflation" that began to engulf the market-oriented industrial economies of North America, Europe, and Japan in the early 1970s seriously threatens economic wrack and ruin if it continues its present course unchecked. The unprecedented and agonizing combination of rapidly rising prices, high rates of unemployment, and declining, and in some cases negative, rates of growth in saving and investment, labor productivity, and real output has, moreover, proved inexplicable within the framework of the Keynesian aggregate-demand-management paradigm and also intractable to the conventional macroeconomic tools of fiscal and monetary fine-tuning. Is it any wonder that the post-Keynesian consensus on stabilization policy, which has been in unquestioned ascendancy since World War II in the United States and other western nations, was so abruptly and completely shattered during the 1970s? Keynesian demand-management policies are now widely viewed as nostrums that cannot cure the ills of the body economic—and may possibly poison it in the bargain.

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The intellectual ferment that has followed the breakdown of the reigning orthodoxy on macroeconomic theory and policy has given rise to the view that the phenomena of stagflation are symptoms of deep and fundamental disorders afflicting the monetary system. Accordingly, calls have issued from various quarters for basic monetary reform. The most prominent and vocal exponents of the view that stagflation is merely a corollary of monetary instability are the monetarists. To their credit, the monetarists' indictment of the current monetary regime for its destabilizing effect on economic activity predates the onset of stagflation. Nonetheless, their advocacy of a "stable and predictable monetary growth rule" within the existing state-monopolized paper fiat currency regime hardly qualifies as a fundamental reform of the monetary system.[1]

Aside from the monetarists, there is another group, small and heterogeneous though its membership may be, which has identified the disorderly monetary system as the source of the current economic malaise. This group of monetary reformers is united in the belief that the key to a stable and well-functioning monetary system is the remonetization of gold in one way or another. Most prominent among these advocates of a gold standard are the proponents of supply-side economics, including Arthur Laffer, Jude Wanniski, George Gilder, Rep. Jack Kemp (R-N.Y.), and even President Reagan himself in the early stages of his campaign for the presidency. The gold standard has also recently been the subject of theoretical and historical studies both pro and con by a number of mainstream economists, including monetary theorist Robert J. Barro, historian Roy W. Jastram, and Edward M. Bernstein of the Brookings Institution.

The Mythology of Gold

The newfound respectability of the gold standard is indeed a far cry from the almost universal disrepute in which it was held in the 1950s and 1960s, the heyday of Keynesian "New Economics." Nonetheless, the gold standard remains for most people, and especially for most economists schooled in the current monetary orthodoxy, something of an anachronism, a relic of a bygone and barbarous age. It is

still widely believed that gold is unfit to perform the functions of money in a modern industrial economy. Indeed, if pressed on the issue, many laymen as well as economists can recite a formidable litany of objections to the gold standard. Unfortunately, despite the wide variation in the cogency and sophistication of these objections, their incessant repetition since the Keynesian revolution of the 1930s has welded them into a structure of myth that stands almost impervious to rational analysis. The advocate of the gold standard must therefore demythologize an institution before he can begin to undertake a rational discussion of it. However, while myths die hard, a strong dose of stagflation may well ease their demise.

Another problem is created by the ambiguity of the term "gold standard": The term has been used to denote a number of diverse historical monetary systems and monetary reform proposals in which gold plays a key role. Since these gold-based monetary systems differ in much more than minor details, the monetary reformer, in order to avoid misinterpretation and misplaced criticism, must specify carefully the precise nature of the gold standard he is proposing.

Under the "pure" or 100% gold standard, which I advocate, money would consist of gold units in whatever sizes and shapes the market deemed most convenient for use in the social process of indirect exchange. Whatever the sizes and shapes in which people desired to hold their money balances, the total quantity of them under this monetary regime would be rigidly fixed at any given time by the total weight of gold owned by all individuals in the economy. This would be true despite the likely development of money-substitutes, i.e., claims to money that are tendered and accepted in monetary exchanges in place of the actual money-commodity. Such claims to money arise when people choose to store a portion of their money holdings in private money warehouses, receiving in exchange warehouse receipts entitling them to redeem their gold on demand. If the money warehouses are generally viewed as reputable firms, then the money-certificates they issue would begin to function as money-substitutes because, under certain circumstances, individual transactors would find it less costly to consummate exchanges without the money-commodity being physically present. The use of money-substitutes would, however, have no effect on the quantity of money because, as noted above, they are warehouse receipts and, as such, are fully "covered" by the gold to which they are instantly redeemable claims. Rather than being a net addition to the money supply, the money-certificates would displace an equal amount of gold in circulation, with the gold so displaced now locked away in the vaults of the various money warehouses. In less apt but more familiar banking terminology, the money warehouses would be legally required to maintain 100% reserves against all demand liabilities.

Money and the State

The fundamental reason for preferring the 100% gold standard to other gold-based proposals for monetary reform is that it is the only monetary system that effects the *complete* separation of the state from the supply of money.[2] Under this system the money-supply process is totally privatized: The mining, minting,

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Regulatory Watch

THE FREEZE

The six-year-old ban on the importation of kangaroo hides has been lifted by the Fish and Wildlife Service despite the protests of environmentalists. Kangaroo hides had previously been imported by the millions for shoes, handbags, and coats until the kangaroo was labeled an endangered species in December 1974. The kangaroo has recently been removed from the endangered list, a decision that will be reviewed by the Interior Department in two years.

The Bureau of Alcohol, Tobacco and Firearms has proposed that pending regulations on ingredient labeling for alcohol be scrapped. The regulations, which were scheduled to go into effect on 1 January 1983, would have required manufacturers to print the ingredients in beer, wine, and other alcoholic beverages on the label. Bureau sources attribute the change in plans to President Reagan's directive that all regulations should be subject to cost-benefit evaluations.

Labor Secretary Raymond J. Donovan's announcement to review and possibly relax federal cotton dust standards brought a flurry of protests and demonstrations from several cotton industry unions. The regulations under review mandate the use of face-mask respirators for workers exposed to cotton dust, but also require that textile firms install dust-removal equipment by 27 March 1984.

The Coast Guard has recently eliminated proposed rules that would require all ships dumping garbage in the ocean to carry electronic surveillance devices. The devices would have recorded both the ship's path and where it dumped its garbage in order to ensure the legality of the dumping procedure. Although the Coast Guard claimed the devices would cost $10,000, later inquiries revealed the cost to be in the $300,000–$500,000 range. The entire idea was abandoned when it was discovered that no commercial manufacturer was interested in producing such a device because only about 100 ships would require them.

According to an internal memorandum that has recently been circulating in the Department of Labor, officials are considering regulations exempting all contractors with less than 250 employees from preparing full affirmative action reports and allowing employers with good records to go without an affirmative action review for up to five years. Before the proposed regulations are announced, they must still be approved by Secretary Donovan and Budget Director David Stockman, neither of whom has expressed his opinion of these changes.

✓Washington Update

✓The Senate Agriculture Committee has defied President Reagan's wishes by approving a dairy price support program that would cost the government $1 billion more than the President wants to spend over the next four years. The Senate committee version of the bill would maintain milk price supports at 75% of parity and reinstate midyear adjustments in the support price. President Reagan planned to lower the parity to 70% and completely eliminate the midyear adjustments.

✓The National Institute of Health has taken what appears to be the first step in ending federal regulation of genetic engineering by creating a subcommittee that has the power to make the regulations purely voluntary. These regulations presently prohibit experiments with certain potentially dangerous organisms and call for special precautions in gene-splicing work. Failure to abide by these rules is currently punishable by a withdrawal of federal funds.

✓The Senate has approved a bill that would send $3.2 billion over the next three years to the International Development Association, an arm of the World Bank that makes development loans to third- and fourth-world nations. The proposed American contribution of $3.2 billion is 27% of the total international contribution, $12 billion. Although the Senate approved a similar bill last year, it died when the House failed to act, a problem that also may plague the current bill.

✓The Department of Agriculture has recently received permission from the Office of Management and Budget to use the OMB's computerized list of federal employees to search for people who are receiving food stamps while working full or part-time for the government. The program, which will consist of a comparison of computer tapes containing data on food stamp recipients and federal employees, will expire in November 1981.

✓The Supreme Court has ruled that employers may not sue their employees for any damages that the employer incurs during a wildcat strike. The ruling arose out of a 1976 dispute between Complete Auto Transit Inc. of Flint, Michigan, and the Teamsters Union after a wildcat strike. The Supreme Court upheld the rulings of two lower courts. Justices Burger and Rehnquist, the two dissenters in a 7-to-2 ruling, felt that the decision left workers totally unaccountable for "admittedly illegal acts."

✓A House committee has voted to kill the Clinch River Breeder Reactor (Tennessee) against the wishes of the Reagan administration. A coalition of critics of nuclear power and fiscal conservatives defeated the bill by a 22-to-18 vote in the House Science and Technology Committee. If the vote is sustained in the full House and Senate it will save approximately $3 billion in completion costs for the 350-megawatt reactor, which was begun in 1970. Budget Director David Stockman opposed the program as a congressman but was presumably overruled within the administration.

✓A House of Representatives subcommittee on housing defeated an amendment supported by the Reagan administration that would deny further subsidized housing for the poor to any area that maintains or initiates rent control on newly built or newly vacated housing. The sponsor of the amendment, Chalmers P. Wylie (R-Ohio), plans to reoffer it in the Banking, Finance and Urban Affairs Committee as well as on the floor.

✓Although the Reagan administration has drawn up a bill for a yacht tax and sent it to Capitol Hill in March, it still has been unable to persuade any congressman to introduce the measure. The proposed tax represents an attempt to get boat owners to pay part of the $1 billion that the Coast Guard spends every year.

✓House members have been granted an extra $2 million a year in official expense allowances by the House Administration Committee in an attempt to keep up with inflation. The increase covers all the expenses that a congressman incurs while keeping in touch with his constituents, except telephone calls and telegrams. Among the largest increases granted were the travel allowance, which rose 65%, the office equipment allowance, which rose 30%, and the postage allowance, which rose 10%. ■

The 100% Gold Standard (Cont. from p. 9)

certification, and storage of the money-commodity as well as the issuance of fully covered money-substitutes are carried out by private firms operating in a free market. In thus removing all vestiges of the state monopoly over money, the pure gold standard provides a virtually inflation-proof currency. It must be remembered that inflation occurs for no other reason than that it benefits whatever group or institution—in almost every case the state—has succeeded in arrogating to itself the monopoly over money creation. Since the state is the first recipient of the new money it creates, it benefits just as a counterfeiter would—by spending the money before prices have risen.

The virtue of the pure gold standard is that it reestablishes the link between socially productive activity and the receipt of money income, i.e., a free market, in the supply of money. All the private firms involved in the money-supply process, from the miners to the issuers of money-substitutes, are constrained to invest scarce resources under the competitive discipline of the market in order to earn a money income. This extends the primary virtues of the free market, justice and efficiency, to the economically vital area of money. Justice is served as the inflationary depredation of the producers is rendered impossible. Concomitantly, the

inefficiencies and distortions that are pandemic in an inflationary economy and are today manifested in stagflation are stopped. Productive activity is reoriented to more faithfully reflect the voluntary preferences of consumers and savers on the market by a price system now free of inflationary distortions.

It should be emphasized that while any form of a gold standard is preferable, from the point of view of justice and efficiency, to the present regime of national fiat currencies, all but the pure gold standard assign a role of some sort to the state.[3] The vital flaw in these watered-down versions of the gold standard is that they are dynamically unstable because the state can be expected to take every opportunity to use its predominant position in the system to further water down and undermine the barriers to its inevitably inflationary predilections. Historically, this instability is borne out by the key role played by the governments of the western nations in the step-by-step transformation of the relatively noninflationary classical gold standard into the nominally gold-based and highly inflationary Bretton Woods system. This almost unrecognizable caricature of the gold standard was administered a merciful death in 1971, and shortly thereafter a regime of fluctuating national fiat currencies was foisted on the world economy. It is no coincidence that inflation in most capitalist nations began to accelerate significantly at about the same time.

One of the charges most frequently brought against the gold standard is that it cannot provide for the monetary needs of a growing economy. Increases in the supply of money, it is said, are necessary to finance the purchases of the increasing quantities of goods and services resulting from economic growth. The gold standard cannot be depended on to produce the required additions to the money supply at the right times or in the correct proportions. The consequence of such monetary deficiency is a stunting of economic growth and stagnation or possibly even a precipitous depression. It is this reasoning that underlay a popular explanation of the Great Depression as stemming from a worldwide shortage of gold. It has also served as the rationale of governments for their implementation of policies that led to the progressive dilution

> **"It is precisely through falling prices that the fruits of economic growth are spread throughout the market economy."**

and eventual collapse of the classical gold standard in the 1930s.

However plausible, this line of reasoning is untenable because it ignores the supply-and-demand mechanism operative in a free market for money. The market ensures that any quantity of money is capable of performing all the work required of a medium of exchange by adjusting its purchasing power to the underlying conditions of supply and demand. The increasing stocks of goods that sellers seek to exchange for money in a growing economy represent an overall increase in the demand for money. If the quantity of money remains unchanged in the face of a growth in real output, the result will be a general bidding down of prices in the economy and, *pari passu*, an increase in the purchasing power of money. With each unit of money now capable of doing more work in exchange, the same quantity of money will suffice to finance the increased volume of transactions.

It is precisely through falling prices that the fruits of economic growth are spread throughout the market economy. For example, if prices in general fall because of a growth in real output, then, all other things being equal, everyone will experience a growth in their real incomes despite the fact that their money incomes remain unchanged. And the worker who saves a portion of his paycheck every week will actually find his savings worth *more* at the end of the year than when he deposited them—quite a welcome change from recent experience! If the government, acting under the false belief that a growth in real output necessitates an increase in the money supply, injects new money into the economy, it will counteract the free-market forces leading to a fall in prices and, consequently, frustrate the natural market process by which productivity gains are distributed throughout society. The result will be that some groups, especially those who receive the new money first—e.g., stockholders and workers in defense firms with government contracts—will appropriate a disproportionate share of the gains at the expense of other groups such as pensioners, annuitants, and others whose money incomes are fixed.

The Flexibility of Gold

Similar considerations apply to the objection that the gold standard is not flexible enough to withstand the bouts of hoarding that may occasionally occur. If not offset by timely injections of new money into the economy, it is argued, such hoarding threatens a shrinkage of expenditure, income, and output that may plummet the economy into a downward spiral of deflation and depression. These fears are groundless, however, because the term "hoarding" denotes nothing more nor less than the voluntary decisions of individuals to reduce their rate of spending in order to increase their money holdings. The result of these decisions is an increase in the aggregate demand for money on the market. If the supply of money is fixed, the increased demand for money will cause prices to fall. Lower prices will translate into a greater purchasing power for the monetary unit, a development that allows the same quantity of money to fulfill people's desires for increased money holdings. Thus "hoarding" or, more properly, an increase in the social demand for money, far from being economically disruptive is in fact a boon. It is the means by which the free market adjusts the purchasing power of individuals' money balances to suit their voluntarily expressed preferences. Once again, any government intervention designed to offset the effects of hoarding merely hampers this market ad-

justment process and frustrates the desires of moneyholders.

This brings us to the criticism that, under the gold standard, the "price level" is unstable and consequently money's effectiveness as a "measure of value" is reduced. Unforeseen changes in its value or purchasing power, it is said, cause businessmen to err in their calculations of revenue and cost and in their subsequent allocation of scarce resources, effect an unjust redistribution of wealth between debtors and creditors, and introduce a general instability into the economy. Without going into a detailed critique of this view, let us note its fundamental flaw. Money is not some sort of measuring device whose value is or should be externally fixed. Money is a commodity chosen by the market as a medium of exchange. Like other goods on the market, it has a price that fluctuates according to changes in its supply and demand. There is no more justification for government to take steps to render the supply-and-demand mechanism inoperative in the case of money than there is in the case of other commodities. In fact, changes in the purchasing power of money have important functions on the market. As we saw above, these include the distribution of the fruits of a growing economy to all the public and the satisfaction of people's desires for changes in their money balances. If the government were to succeed in freezing the purchasing power of money, i.e., in "stabilizing the price level," money would be rendered incapable of performing these vital functions. In practice, of course, the attempts of modern governments to achieve a stable price level through manipulations of the money supply have succeeded only in seriously destabilizing the economy (witness our present stagflation) while, at the same time, rendering the purchasing power of money much more volatile than it was, e.g., under the classical gold standard.

Friedman's Criticism

One final criticism of the gold standard that has been voiced by Milton Friedman, among many others, is that "it is not desirable because it would involve a large cost in the form of resources used to produce the monetary commodity."[4] Surprisingly, many staunch defenders of the gold standard, from Adam Smith to Ludwig von Mises, have conceded the point to their opponents that the scarce resources expended in the provision of a commodity money represent an economic loss to society because these resources are diverted from the satisfaction of human wants. Advocates of the gold standard like Mises argue, however, that "if one looks at the catastrophic consequences of the great paper money inflations, one must admit that the expensiveness of gold production is the minor evil."[5]

On the other hand, opponents of gold

GOVERNMENT RECEIPTS MONITOR

On a quarterly basis, *Policy Report* presents three monitors of economic activity: "Government Spending," "Government Receipts," and "Inflation." This month, the "Government Receipts Monitor" summarizes the latest levels and sources of the federal government's income.

RECEIPTS (annual rate in millions of $ unless otherwise indicated)

	1981 First Quarter	1980 Fourth Quarter	1980 Third Quarter	Average for Last Year
Total Receipts	625,292	524,200	540,604	578,747
Surplus or Deficit	− 128,208	− 134,220	− 129,348	− 89,858
Total Individual Income Taxes	309,340	266,950	264,944	278,863
Gross Corporate Income Taxes	59,376	58,108	49,348	67,913
Employment Taxes and Contributions	172,056	124,408	143,668	149,549
Social Insurance Taxes and Contributions	189,432	142,412	166,640	172,087
Unemployment Trust Fund	10,036	11,168	15,804	15,520
Excise Taxes	40,056	28,996	32,332	32,614
Highway Trust Fund	6,640	6,228	6,352	6,502
Estate and Gift Taxes	6,384	6,680	7,316	6,679
Customs Duties	7,420	7,328	7,540	7,299
Miscellaneous	12,388	12,984	12,288	12,835
Holding of Public Debt Securities (current total)	950,498	910,062	887,553	905,823
Holding of Agency Securities (current total)	6,399	6,531	6,670	6,594
Federal Securities Held by Public (current total)	763,449	720,461	698,092	716,482

SOURCE: *Monthly Treasury Statement of Receipts and Outlays of the United States Government.*

urge that the substitution of a practically costless and "well-managed" paper fiat currency would yield substantial benefits to society because the productive resources previously tied up in gold mining as well as the monetary stock of gold itself would be free to be allocated to the production of producers' and consumers' goods, leading to a net increase in the satisfaction of wants.

The foregoing is a most persuasive argument that has seduced many good economists out of sound habits of thought. The flaw in the argument is that it proves too much. Thus, it could be argued, by analogy, that the tremendous diversity in clothing styles and colors on the free market involves a wasteful expenditure of resources that curtails human want-satisfaction in other areas. If only a "well-managed," i.e., state-monopolized, production and distribution system for clothing could be organized, the cost of providing the populace with clothing would be drastically cut. And no doubt the outfitting of the whole population with gray Mao pajamas would diminish, possibly substantially, the physical amount of resources devoted to producing clothes. But any free-market economist worth his salt would reject this proposal out of hand as hardly optimal from an economic standpoint because he would understand that, all things considered, the current level of resource expenditure for the production of clothing is economically justified, as high as it might be in some absolute sense. The market has revealed, he would say, the the resources presently employed in the clothing industry have a higher value there than in alternative employments. Any redeployment of resources by a state clothing monopoly, therefore, no matter how well-managed, would result in a net diminution in the satisfaction of human wants.

But the same chain of reasoning holds, link for link, in the case of a commodity that emerges as money on the market. Thus gold has been chosen as money by the market because, all things considered, it best serves the functions of money. This implies that gold has a higher value in monetary use than in all other possible uses in the economy (abstracting for the sake of argument from the residual nonmonetary uses of gold). Since the market has never deemed inconvertible paper tickets issued by one agency fit for monetary use, it is clear that a paper fiat currency is not cheaper than a gold currency in the relevant economic sense. The substitution of a state-monopolized paper fiat currency in the place of gold therefore brings about a misallocation of resources in the economy which, *ipso facto*, raises costs in the economy—and this apart from the misallocations induced by the inflation which will inevitably follow.

> **"Like other goods on the market, money has a price that fluctuates according to changes in its supply and demand."**

The Denationalization Process

Some monetary reformers, most prominent among them Friedrich A. Hayek, have urged that money be privatized or "denationalized" through a regime of competing, privately-issued, inconvertible paper currencies.[6] Two brief points can be made regarding this scheme. First, if competitive paper currencies or any other commodity were to win out over gold as the chosen money in a free market, then so be it. The desideratum of the 100%-gold-standard advocate is a purely private, market-chosen money. However, historical experience as well as economic theory seem to strongly militate against the eventuality of a competitive paper currency standard displacing a gold standard on the free market. Second, it is important to realize that in our present situation a private money could emerge only after a long and complicated "denationalization" process. Needless to say, the course of this process and therefore the private monetary regime that eventually emerged from it would greatly depend upon certain concrete actions undertake by the state. It is my belief that the course of any future privatization process should be dictated by considerations of justice and not of utilitarian speculation. I do not think that monetary reformers should attempt to determine in advance and without aid of the market what kind of private money would be optimal and then urge the state to arrange the privatization process accordingly. Rather, they should press for the immediate convertibility of the dollar into a fixed weight of gold. Whether or not this is stacking the deck in favor of the gold standard is beside the point. In rendering the dollar inconvertible, the state committed an infringement of private property rights that must be redressed as soon as possible by returning the gold to private hands. In reestablishing the redeemability of the dollar in gold, the state is simply recognizing and discharging the legitimate claims of individuals to the gold in its physical possession. As such, this is the just and natural first step to be taken in the privatization process. Once the privatization process is completed and there is a fully private gold standard in existence, there will be time enough for the market to decide if gold should continue as money. ■

[1]For a recent critique of the monetarist proposal from the point of view of a global monetarist, see Marc A. Miles, "The Monetary Crisis: Why Quantity Rules Are No Solution," *Policy Report* 3, no. 5 (May 1981): 5–11.

[2]This is not strictly true. The gold-reserve free banking system advocated by Ludwig von Mises and the competitive-paper-currencies scheme recently proposed by Friedrich A. Hayek also envision no role for the state in their operation, save for the enforcement of contracts. My main objection to Mises's proposal is politico-ethical and not economic. It stems basically from a difference in views on property rights that cannot be gone into here. Suffice it to say that the issuance of money-substitutes by banks in excess of their gold deposits is considered by proponents of the 100% gold standard a fraudulent (and inflationary) infringement of property rights on the part of the banks. My objection to Hayek's proposal is economic and will be dealt with very briefly below.

[3]With the exception of gold-reserve free banking noted in the previous footnote.

[4]Milton Friedman, "Should There Be an Independent Monetary Authority," in *In Search of a Monetary Constitution*, ed. Leland B. Yeager (Cambridge, Mass.: Harvard University Press, 1962), pp. 223–24.

[5]Ludwig von Mises, *Human Action: A Treatise on Economics*, 3d rev. ed. (Chicago: Henry Regnery Company, 1966), pp. 421–22.

[6]F. A. Hayek, *Denationalization of Money*, 2d ed. (London: Institute of Economic Affairs, 1978); idem, "Toward Free Market Money," *Wall Street Journal*, 19 August 1977.

"To be governed . . ."

To tell the truth

As the battle of the budget begins in earnest in the House today, quips one Budget Committee liberal, "It's our phony figures against Reagan's phony figures."

—*Wall Street Journal*, Apr. 6, 1981

At least they're breathing

The city's acting police chief said today he doesn't care if some police recruits can't spell or drive cars, because "you don't need to be an Einstein to be a policeman." . . . [Jack] Warren said he wasn't concerned about reports in the Birmingham Post-Herald that one new recruit misspelled all 25 words on a routine spelling test. The newspaper said the words included Birmingham (Bihainham), Wednesday (wesding), burglarized (bilit), allegedly (orang), abandoned (orb), and unauthorized (ounraster).

The newspaper also reported that one recruit, who has since been certified for the force, failed her driving tests and overreacted in simulated shooting incidents. The newspaper said she shot her weapon in every simulated shooting incident during the 14-week course.

—*Washington Post*, Apr. 22, 1981

Land of the free

Any new [immigration law] enforcement program must include sanctions against employers who hire and exploit illegal aliens . . . and present a new and secure system to ensure that job applicants are authorized to work legally in the United States. Among suggestions thus far presented is one to include a secure, counterfeit-resistant type of identification permit for all workers . . . [to be] presented only at the time of seeking employment. The permit might simply say: "I am authorized to work and be employed in the United States of America." It is also possible that work authority information could be entered into a data bank.

—Sen. Alan K. Simpson, *Washington Post*, Apr. 28, 1981

Small change

A Congressional Budget Office prediction of an inflation-caused $136 billion overrun in President Reagan's five-year defense program . . . should be put in context, David A. Stockman, director of the Office of Management and Budget, told a House Government Operations subcommittee.

"It only amounts to 8 percent of the total base of [defense] spending that would occur during that period," he said.

—*Washington Post*, Apr. 8, 1981

Please—sit behind a desk and read reports

Donovan, who personally led recent Labor Department raids against sweatshops in the garment districts of New York City and Chicago, vowed to redouble his efforts to crack down on firms that violate federal wage and hour laws.

"I didn't take this job to sit behind a desk and read reports," Donovan told the Business Roundtable in a speech yesterday.

—*Washington Post*, May 20, 1981

But Texas Tech *is* in Lubbock

An article in the April 5 editions of The Washington Post presented an inaccurate depiction of Texas Tech University and the city in which the university is located, Lubbock. Texas Tech students do not carry guns to class, as the article stated, and the city itself is a quiet town with orderly and law-abiding citizens. There is no "pistol-packing" tradition in Lubbock, as the article incorrectly implied.

—*Washington Post*, Apr. 30, 1981

If at first you don't succeed

A 15-year federal program designed to inform the public about the health hazards associated with cigarette smoking has largely failed, and tougher warnings on these risks are needed on cigarette packages, the Federal Trade Commission warned yesterday.

—*Washington Post*, May 21, 1981

Defending free enterprise

The U.S. should have a standby rationing program, Mobil Corp's president William P. Tavoulareas, said at the annual meeting.

In an oil-supply crisis, the U.S. should hand out tickets to consumers and allow them to sell unused tickets to others who want more, the executive said.

—*Wall Street Journal*, May 8, 1981

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